Supreme Court, U. S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1977.

No. 77-814

HEIZER CORPORATION,

Petitioner,

vs.

PETER WRIGHT, BENEFICIAL STANDARD CORPORATION AND IDC SERVICES, INC.,

Respondents.

BRIEF IN OPPOSITION TO PETITION FOR CERTIORARI.

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Method of Citation.

Citations to the Petition are given as "Pet."; citations to the Appendix to the petition are given as "A" followed by the page number therein. Citations to plaintiffs' exhibits and defendant's exhibits are given as PX and DX, respectively, and citations to the trial record are given as "Trial Tr." followed by the page therein. Citations to papers other than the foregoing, included in the record on appeal are given as "R." followed by the index number of said paper.

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PETER WRIGHT, BENEFICIAL STANDARD CORPORATION AND IDC SERVICES, INC.,

Respondents.

BRIEF IN OPPOSITION TO PETITION FOR CERTIORARI.

Respondents pray that the Petition for Writ of Certiorari be denied.

QUESTIONS PRESENTED.

The questions which petitioner purports to present to this Court are nicely framed as important issues involved in the administration of the federal securities laws. (Pet. 2-3) But examination of petitioner's subsequent argument reveals that the only real questions presented are: (a) whether the evidence was sufficient to establish petitioner's liability for violations of Section 10(b) of the Securities Exchange Act of 1934; and

(b) whether the evidence supported the equitable relief granted below. This Court has heretofore condemned the practice of misstating the questions in such fashion. *Southern Power Company* v. *North Carolina Public Service Company*, 263 U. S. 508, 509 (1924).

Questions respecting the power of the courts below to fashion the relief granted (Pet. 3) were not raised below and may not be raised in the petition for the first time. *United States* v. *Ortiz*, 422 U. S. 891, 898 (1975); *Tacon* v. *Arizona*, 410 U. S. 351, 352 (1973); *Adickes* v. *Kress & Co.*, 398 U. S. 144, 147 n. 2 (1970).

Petitions such as the present one, which pay lip service to Rule 19 of this Court, but actually involve no more than evidentiary disputes, or matters raised for the first time in this Court, fly in the face of the stern admonition of this Court in *Southern Power, supra.*

ADDITIONAL STATEMENT OF THE CASE.

1. Introduction.

Petitioner's statement of the case is inaccurate in that it omits pertinent facts found by the courts below as well as facts undisputed in the record.

Petitioner presents a false picture of itself as a misguided but nevertheless honestly motivated investor in IDC. But the findings of four judges below, as well as the undisputed facts in the record, establish otherwise. As hereinafter shown, once petitioner gained control of IDC it proceeded to engage in a series of concealed, self-dealing transactions, intentionally structured to insure that it would capture substantially all of the profits if the business succeeded, but would suffer none of the losses if it failed.

These transactions were characterized by the District Court as "rapacious" and "more rapacious," and were condemned by the Seventh Circuit as a "heads-I-win-tails-you-lose series of transactions." (A30) A fair and complete statement of the case as set forth hereunder fully supports these assessments.

2. Nature of the Action.

Plaintiffs below (respondents here) are minority common stockholders of IDC Services, Inc. ("IDC")[1] suing derivatively. In their second amended complaint, brought under Section

1. In November, 1969, IDC had at least 35 stockholders holding an aggregate of 840,000 shares. Twenty-five stockholders bought their shares for cash at prices between 15¢ and $5.00 per share; the balance paid in services or by exchanging their stock of Talent & Residuals, Inc. for IDC stock. (PX 62, pp. 16-17) The same persons were shareholders in September, 1970, PX 9, and there is no evidence that this situation had changed any time during the period in suit. Respondent Wright paid $5.00 per share for his 2,500 shares; respondent Beneficial paid an average of $2.50 per share for its 170,000 shares. (PX 62, pp. 16-17)

10(b) of the Securities Exchange Act of 1934, 15 U. S. C. § 78j(b) and Rule 10b-5 thereunder, 17 C. F. R. § 240.10b-5, plaintiffs challenged a series of five securities transactions between IDC and defendant Heizer Corporation (petitioner here).

3. The First Three Transactions.

The first three transactions were found by the District Court to be free of any 10b-5 fraud. (A63)[2]

Each of these transactions was approved by IDC's common stockholders at a meeting called and held pursuant to notice. Documents pertaining to each of the transactions were made available to the common stockholders prior to each meeting. (A62)

In the first transaction, in November, 1969, petitioner acquired 100,000 shares of preferred stock of IDC at $10.00 per share, and warrants to purchase 155,000 shares of common stock at $8.50 per share, equivalent to approximately 15% of IDC's pro forma common stock equity. The warrant agreement contained an antidilution clause which would automatically adjust the price downward and the number of shares purchaseable upward if IDC later sold stock or rights to stock at a price lower than $8.50 per share.

In the second transaction, in September, 1970, petitioner acquired an additional 200,000 shares of preferred stock at $10.00 per share and a second warrant to purchase an additional 400,000 shares of common stock at $6.00 per share. The second warrant also contained a similar antidilution clause. Petitioner agreed not to enforce the antidilution clause in its first warrant. After the second transaction, petitioner held warrants to purchase 555,000 shares of IDC common, or approximately 40% of IDC's pro forma common stock equity.

In the third transaction, in May, 1971, petitioner loaned IDC $1,700,000 on a 20-year note and acquired a third warrant to

2. Respondents did not appeal from this ruling.

purchase 472,222 shares of common stock at $3.60 per share. The third warrant also contained a similar antidilution clause. The antidilution clauses in the earlier warrants were triggered, increasing the number of shares purchaseable thereunder and decreasing the purchase price thereof. As a result, at the end of the third transaction, petitioner held warrants to purchase 1,304,000 shares of IDC common stock at $3.60 per share, equivalent to 61% of IDC's pro forma equity.[3]

An additional feature of the third transaction was an amendment of IDC's certificate of incorporation increasing the voting rights of petitioner's preferred stock to 4.4 votes per share, giving petitioner 61% voting control over IDC. (A48)

While the District Court found that "the first three transactions were not tainted by any 10b-5 fraud . . ." (A63), in the next sentence it expressly stated: "The fourth and fifth transactions are quite different." (*Id.*)

4. The Fourth Transaction.

At the time of the fourth transaction petitioner admittedly was in control of IDC (Trial Tr. 688) and had two representatives on its five-man board of directors. (A18)

IDC was then experiencing financial difficulties because of losses in its television monitoring business; but it was not bankrupt.[4] The fair value of its common stock was $3.60 per share, as determined by petitioner's expert evaluation and as admitted by petitioner's president at trial. (A63; PX 48) At this

3. The precise number of shares purchaseable as a result of the triggering of the antidilution clauses in the earlier warrants was adjusted by negotiation and was not the result of a pure application of the formula. (A8 n. 6)

4. The testimony of petitioner's expert that IDC was bankrupt at the time of the fourth transaction (Pet. 9) was subjected to intense cross-examination (Trial Tr. 2244-84), and not found credible by the trial court. Otherwise, that court could not have found that the value of IDC's common stock at that time was $3.60 per share. (A63)

point petitioner valued IDC's wholly-owned subsidiary, Talent & Residuals, Inc. ("T&R), at $4.8 million, and valued IDC as a whole at $7.2 million (PX 48). Thus, immediately prior to the fourth transaction, petitioner's investment in IDC of $4.7 million was well secured.[5]

In the fourth transaction, pursuant to a loan agreement dated November 19, 1971, petitioner agreed to loan IDC $275,000 immediately and, *at petitioner's election,* to loan it an additional $325,000, or a total of $600,000. (PX 14) The loans were evidenced by notes payable on demand after March 31, 1972.[6] In addition, IDC was deemed to have borrowed all amounts due petitioner under a management agreement with petitioner, as well as interest accrued on the 20-year note issued in the third transaction. If all of these loans, aggregating $714,508 were not repaid, within a very short time, by March 31, 1972, then, pursuant to the agreement, the notes would become convertible into common stock of IDC at a price of $1.00 per share. (A48-49; PX 14) In the event the notes became convertible, the antidilution clauses in all of the earlier warrants would be triggered, as a result of which the total number of shares purchasable thereunder would increase from 1,304,000 to 4,694,000 and the purchase price would decrease from $3.60 to $1.00 per share. (A49; PX 14)

5. Petitioner's motivation in entering into the fourth transaction seems clear. If it had doubted the continued viability of IDC, it could have forced a liquidation and recaptured its investment intact. It did not, but chose to continue to finance IDC's monitoring business, although not compelled to do so, obviously with the expectation that it would become profitable and that the expected return would far exceed the risk, which was minimal. Indeed, 18 months later petitioner was advising its own stockholders that by 1979 it expected its then $7.5 million investment in IDC to be worth $50 million. (PX 69, p. 7) Alternatively, petitioner could have permitted IDC to terminate monitoring and to repay petitioner's $4.7 million out of T&R's fully tax-sheltered earnings which petitioner projected at $657,000 for 1972, $788,000 for 1973 and $946,000 for 1974. (PX 48)

6. The funds were actually advanced as follows: 11/15/71, $60,000; 11/19/71, $215,000; 12/17/71, $100,000; 1/10/72, $125,000; 3/1/72, $100,000. (PX 54)

The $1.00 per share conversion price had been fixed by petitioner, and, according to its president, had no relation to book value, earnings, market value or any other recognized valuation method. (Trial Tr. 190-192, 695-698) Petitioner admitted that it formulated the $1.00 price in order to trigger the antidilution clauses in petitioner's earlier IDC warrants, and thereby to equate its claim on IDC's common stock equity to the percentage which its total investment (both debt and preferred stock)[7] bore to IDC's total capital. (A64; Trial Tr. 701-02)

Petitioner's president also admitted that at the time of the fourth transaction, he knew there was virtually no chance that IDC could repay the loans made thereunder on their maturity date of March 31, 1972. (A49; Trial Tr. 710-711)

At the time of the fourth transaction petitioner was simultaneously negotiating with an independent investment banker, McCormick & Company, for a public offering of IDC securities, including warrants for IDC common stock at an exercise price of $4.00 per share. (DX 78; Trial Tr. 2054) As one of the conditions for petitioner's consent to the financing, it was to receive 100,000 of these $4.00 warrants. (DX 82)

An express condition of the fourth transaction was the amendment of IDC's certificate of incorporation to increase the number of authorized common shares from three million to seven million. (A49; PX 14) Without this amendment petitioner's scheme could not have worked. (A16n.10) For this reason, the Court of Appeals described this condition as a "critical element." (A16)

Because of IDC's need for funds, it was decided to obtain written consents to the amendment from a majority of IDC's common stockholders, in lieu of a meeting, as permitted by Delaware law. (A10) Petitioner delegated to its counsel responsibility for obtaining such consents. (Trial Tr. 738, 741-743)

7. Petitioner has never owned any IDC common stock. Its investments initially were and always remained in IDC senior securities.

At the time that the consents were obtained, the directors of IDC had not yet approved the transaction and drafting of the agreement had not yet been completed; no documents containing the terms of the agreement accompanied the bare consent forms. (Trial Tr. 1784, 1785) The consent form itself contained no information about the transaction. (PX 16)

Petitioner knew that its counsel was supervising and controlling communications to IDC shareholders, and that he had drafted the form of consent to be executed by the common stockholders. (A18) Petitioner knew that the necessary consents from the common stockholders would be obtained by Jordan Ross, one of IDC's directors (A10); that there was strenuous opposition to the transaction from respondent Beneficial Standard Corporation, IDC's largest independent shareholder after Ross (A25); and that numerous other independent shareholders would therefore have to be solicited (A10).

Ross was given no instructions on what he should tell the shareholders when he orally solicited their consents, nor was any inquiry made as to what he had said when he returned, approximately a day and a half later, with the signed consent forms. (A25-26)

The bare consent forms were executed by the holders of 437,250 shares of common stock or approximately 52% of the total outstanding. Of these, 283,800 were held by IDC directors (LeBow, 18,000 shares; Ross 265,800); and 5,000 shares were held by IDC's counsel. (PX 16) None of the other common stockholders who executed consents were given any explanation of the terms of the transaction or any documents reflecting such terms. (Trial Tr. 227-233; 350-352; 409) No evidence to the contrary was introduced at trial.

As previously noted, by the time that four of IDC's five directors,[9] including two representatives of petitioner, met to

9. Respondent Beneficial Standard Corporation's representative on IDC's board was not present; he was out of the country at the time. (A9) However, Beneficial Standard Corporation had previously registered its strong objections to the terms of the fourth transaction. (A25)

approve the fourth transaction on November 19, 1971, the consent of a majority of the common shareholders had already been obtained. (DX 93, pp. 2-3)[10] But at this time, IDC's bylaws did not permit corporate action by written consent of a majority of its shareholders. Thus, the first act taken at the November 19, 1971 board meeting was the amendment of IDC's bylaws to allow shareholder action by consent in lieu of a meeting. (*Id.*) The express reason for that amendment was to validate the consents to the fourth transaction which had previously been obtained. (*Id.*)

On March 13, 1972, pursuant to amendment to the fourth transaction agreement, petitioner loaned IDC an additional $105,000.[11] It was known to petitioner on that date that IDC would be unable to repay this loan on its maturity date, March 31, 1972 out of internally generated cash or any outside source of financing. (Trial Tr. 732)

On March 31, 1972, none of the loans made under the fourth transaction, or the amendment thereto, was paid by IDC. As a consequence, the notes evidencing said loans, now totaling $819,508, including $114,508 of accrued interest and management fees, became convertible into IDC common stock at $1.00 per share. Because of this the antidilution clauses in all of petitioner's earlier warrants were triggered, increasing the number of shares purchasable thereunder from 1,304,000 to 4,694,400, and reducing the purchase price from $3.60 to $1.00 per share.

Thus, as a result of the fourth transaction, for an additional investment of only $819,508 petitioner increased its claim on IDC's common equity to 5,513,908 shares (4,694,400 in warrants, plus 819,508 in convertible notes) or 87% at $1.00 per share. (A50, 63; R. 134, Stip. Nos. 42-45) Petitioner's president testified that he doubted "we" would have permitted an independent third party to invest in IDC on the same favorable

10. DX 93 is a verbatim transcript of a tape recording of the directors' meeting of November 19, 1971.

11. Respondent Beneficial Standard Corporation's representative on IDC's board voted against the additional loan. (A49-50)

terms which petitioner obtained in the fourth transaction. (Trial Tr. 888)

5. The Fifth Transaction.

At IDC's annual meeting of stockholders on May 25, 1972, petitioner elected a majority of IDC's directors. (A50) Thereafter, IDC, under petitioner's control, continued to borrow from petitioner on a demand note basis, to finance its monitoring business. By June, 1973, these demand loans aggregated $2 million. (PX 25, Sched. A) On October 11, 1972, respondents commenced this action in the District Court, challenging the first four transactions and petitioner's control of IDC. On June 8, 1973, petitioner's nominees on IDC's board caused IDC to pledge to petitioner all of the shares of IDC's wholly owned subsidiary, Talent & Residuals, Inc. ("T&R"). (A19)

The pledge secured the $2 million in demand loans and provided that petitioner would make additional demand loans to IDC during the balance of 1973 in a maximum amount of $1,181,700, and a minimum amount of $460,400. It further provided that petitioner would refrain from making demand for repayment of the prior loans as well as the additional loans for six months, until January 2, 1974. (PX 25)

Finally, the agreement provided that all of petitioner's obligations thereunder were terminable if IDC should commit an event of default under the agreement. Events of default were defined to include "default in the payment of or material nonperformance of any liability or obligation of IDC to H. C. [Heizer]." (PX 25, p. 6) In the event of such default the agreement expressly empowered petitioner to foreclose on the T & R stock "without notice or demand." (*Id.* at p. 5)

T&R's earnings before taxes had increased from $58,000 in 1968 to $523,000 in 1972. (PX 24, p. 21) By contrast, IDC's monitoring operations had never been profitable; from 1969 through 1972 it suffered aggregate losses of $5.7 million. (*Id.* at p. 18) At the time of the pledge T&R had been valued

at $7.5 million by an independent expert. (PX 24, p. 21) Petitioner itself valued T&R at $8 million. (A64; PX 50) Petitioner knew then that IDC could not repay any of the loans secured thereby on January 2, 1974 out of internally generated funds or from any known outside source of financing (A64; Trial Tr. 913-915, 1242-45)

Petitioner admitted that the pledge was unnecessary to secure repayment of its loans. (A23; Trial Tr. 933, 936-937) The real reason for the pledge was to protect petitioner against any adverse outcome of this litigation which was then pending (A24, A64) If respondents were successful in obtaining the relief sought, petitioner would lose control of IDC and would be locked into a senior position. (A24) Petitioner candidly admitted as much in its brief in the Court of Appeals. (Opening Brief of Heizer Corp., p. 49) The pledge was taken by petitioner to prevent this result. (A64)

No meeting of the common stockholders of IDC was held to consider the pledge. At no time prior to or after the pledge was disclosure of its terms made to the common stockholders of IDC, other than Jordan Ross, who voted against it at the director's meeting. All this was admitted by petitioner in its answer to the second amended complaint. (R. 63, Count II, ¶ 25)

IDC's common stockholders were first informed of the existence of the pledge by letter two months later. (PX 53, p. 5) The letter contained no disclosure:

a) of the true purpose of the pledge (*i.e.*, to insulate petitioner from the possible adverse outcome of the litigation);

b) of the total amount of indebtedness secured and to be secured by the pledge;

c) of the fact that there was no possibility of repayment of this indebtedness by January 2, 1974; or

d) of the value of the asset pledged. (*Id.*)

One month later respondents, having obtained a copy of the pledge through discovery, amended their complaint and sought rescission under Section 10(b).

6. The Petition for Supplemental Relief.

After trial, but before the District Court rendered its decision, respondents filed a petition for supplemental relief charging that, in a series of transactions after it gained control of IDC, petitioner imposed a total of $5 million in demand loans on the corporation to finance the monitoring venture at a time when it also held a claim on 87% of IDC's common stock equity. Respondents alleged that these note transactions were both a fraud on IDC and its common stockholders as well as a breach of petitioner's fiduciary duty, because, with its warrants and convertible notes, petitioner would reap substantially all of the profits, if the monitoring venture succeeded,[12] but if it failed, petitioner would use its notes to recapture its investment in full, thus shifting the entire burden of loss to IDC and its common stockholders. Respondents sought an offset of the amount of the monitoring losses against these notes. (R. 83) Subsequently, respondents urged, as an alternative ground, that the notes be transformed into common stock. (R. 101)

7. The Decisions of the Courts Below.

A. Liability.

In its Memorandum Opinion of December 3, 1975, the District Court did not in so many words address itself to the issues of nondisclosure or scienter in the fourth and fifth transactions. It chose to rest its finding of liability on petitioner's self-dealing and breach of fiduciary duty in the fourth and fifth transactions. (A63-64) However, immediately following its finding that the first three transactions were fully disclosed and free from fraud,

12. In 1973 petitioner had projected that by 1979 its investment in IDC would have a value of $50 million. (PX 69, p. 8)

it expressly stated that, "The fourth and fifth transactions were quite different." (A62-63) Further, it characterized petitioner's conduct in the fourth and fifth transactions as rapacious. (A64) The Court of Appeals did not disturb these findings.

In a subsequent opinion on May 28, 1976, the District Court denied respondents' petition for supplemental relief which had challenged the $5 million in demand loans.

After the District Court's decision in December, 1975, this Court decided *Ernst & Ernst* v. *Hochfelder*, 425 U. S. 185 (1976). Prior to oral argument in the Court of Appeals this Court decided *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U. S. 438 (1976). While the case was *sub judice* in that court, this court decided *Santa Fe Industries* v. *Green*, 430 U. S. 462 (1977). In its opinion the Court of Appeals expressly took note of these decisions and rejected the reasoning underlying the District Court's finding of liability. It then proceeded to review the record to determine whether, in the light of *Hochfelder*, *Northway* and *Green* the judgment of the District Court should be affirmed on grounds other than those relied upon by that court. (A15) After its review of the pertinent facts established at trial, none of which were in dispute, the Court of Appeals concluded that the evidence established the materiality, nondisclosure (A15-21), reliance and scienter (A21-27) necessary to affirm the judgment of the District Court on the issue of liability in the fourth and fifth transactions.

B. Relief.

In granting retrospective relief the District Court cancelled the conversion feature of the notes issued in the fourth transaction, as well as the additional warrants obtained by petitioner through the triggering of the antidilution clauses in the earlier warrants. It also voided the pledge agreement in the fifth transaction. (A64-68, 69-70) In substance, insofar as petitioner's claims on IDC's equity or liens on IDC's assets were concerned, the District Court returned petitioner to the position it was in prior to the fourth transaction.

In granting prospective relief the District Court enjoined petitioner from exercising any of its warrants in the future at a price of less than $3.60 per share (A68-69) In addition, in the light of petitioner's past conduct, it enjoined petitioner from entering into any future transactions with IDC except upon fair and equitable terms. (A66, 70)

While the case was on appeal, petitioner submitted a plan of recapitalization to IDC's common shareholders. Petitioner threatened to put IDC into bankruptcy if the common shareholders did not approve the plan. On June 18, 1976 the District Court entered an injunction pending appeal enjoining petitioner from consummating the plan and from collection of the demand notes. (A78-79)

The Court of Appeals affirmed the retrospective relief granted by the District Court. (A27-28) It reversed the prospective relief relating to the future exercise of any of petitioner's warrants at less than $3.60 per share. (A33-34) It modified the relief respecting future transactions between petitioner and IDC, deleting the District Court's broad equitable injunction and substituting a lesser form of relief governing such future transactions. (A32-33) It also affirmed the District Court's injunction pending appeal. (A30-31)

The Court of Appeals also reversed the District Court's dismissal of respondents' petition for supplemental relief and remanded the cause to the District Court for further proceedings to adjust the maturities of the demand loans to make them commensurate with IDC's ability to pay. (A28-31)

REASONS FOR DENYING THE WRIT.

1. The petitioner seeks no more than a review of the sufficiency of the evidence and the inferences drawn therefrom. Granting of the writ for this purpose is not warranted. *General Talking Pictures Corp.* v. *Western Electric Co.*, 304 U. S. 175, 178 (1938); *Southern Power Co.* v. *North Carolina Public Service Co.*, 263 U. S. 508, 509 (1924). The wisdom of this Court's long-standing policy of declining to grant the writ merely to review the sufficiency of the evidence, or inferences therefrom, is well illustrated here. Due to petitioner's persistent argument that the Seventh Circuit improperly viewed the evidence, respondents have been compelled to refer often and in detail to the record, necessarily prolonging this brief, and, with extreme reluctance, imposing an otherwise avoidable burden on the time of this Court.

2. The court below adhered to the accepted and usual course of judicial proceedings in examining the trial record to determine if the judgment of the District Court should be affirmed on grounds other than those relied on by that court. *Dandridge* v. *Williams*, 397 U. S. 471, 475 n. 6 (1970); *Jaffke* v. *Dunham*, 352 U. S. 280, 281 (1957); *United States* v. *American Railway Express Co.*, 265 U. S. 425, 435-36 (1924). Petitioner's argument to the contrary is inconsistent with its position in the court below and is improperly raised for the first time in its petition for certiorari. *United States* v. *Ortiz*, 422 U. S. 891, 898 (1975); *Tacon* v. *Arizona*, 410 U. S. 351, 352 (1973); *Adickes* v. *Kress & Co.*, 398 U. S. 144, 147 n. 2 (1970).

3. The decision of the court below carefully considered and followed the controlling decisions of this Court on the issues of both liability and relief. *Ernst & Ernst* v. *Hochfelder*,

425 U. S. 185 (1976); *TSC Industries* v. *Northway, Inc.*, 426 U. S. 438 (1976); *Santa Fe Industries* v. *Green*, 430 U. S. 462 (1977); *Mills* v. *Electric Auto-Lite Company*, 396 U. S. 375 (1970). No important issue involving the administration of the federal securities laws is raised by the petition. Compare *Santa Fe Industries, Inc.* v. *Green, supra* at 470-471.

4. The court below did not decide the case on the ground of vicarious liability; hence, any supposed conflict between the circuits on the standard of liability under Section 20(a) of the Securities Exchange Act of 1934 is not pertinent here. Even if it were, petitioner argues no more than that the evidence established its statutory defense to controlling person liability under Section 20(a); thus again, petitioner raises only a dispute over the sufficiency of the evidence and inferences drawn therefrom.

ARGUMENT.

I.

THE COURT OF APPEALS FOLLOWED PROPER PROCEDURE IN AFFIRMING THE DISTRICT COURT WITHOUT REMAND FOR RECONSIDERATION BY THAT COURT. PETITIONER CANNOT RAISE THIS ISSUE FOR THE FIRST TIME IN THIS COURT.

A. The Procedure Followed Was Proper.

The court below acted properly in reviewing the record and affirming the District Court on grounds other than those relied on by that court. *Dandridge* v. *Williams*, 397 U. S. 471, 475 n. 6 (1970); *United States* v. *American Railway Express Company*, 265 U. S. 425, 435-36 (1924). As the successful parties in the District Court, respondents may properly sustain their judgment on any ground supported by the record. *Jaffke* v. *Dunham*, 352 U. S. 280, 281 (1957).

It may be noted that on the same day that the court below heard oral argument in the present case, the identical panel also heard oral argument in *Sanders* v. *John Nuveen & Co., Inc.*, 554 F. 2d 790 (1977). *Sanders* had been remanded by this Court to the Court of Appeals for further consideration in light of *Ernst & Ernst* v. *Hochfelder*. In compliance with this direction the Court of Appeals reviewed the full trial record in that 10b-5 case to determine whether there was sufficient evidence to sustain a finding of reckless behavior by defendant, and concluded that there was not. (*Id.* at 793)

If this Court had felt that proper procedure required reconsideration by the District Court in the first instance, presumably such instruction would have been included in the *Sanders* mandate.

B. Petitioner Should Not Be Permitted to Raise the Issue of Remand for the First Time in This Court.

Petitioner contends that the court below should have remanded the case for reconsideration by the District Court because "the whole framework of the litigation ha[d] been altered by several intervening decisions of a higher court . . ." (Pet. 14) Petitioner made no such argument below. To the contrary, in its opening brief below petitioner stated:

> "Because all issues were fully aired at trial and this appeal raises purely legal issues, *there is no need to remand the case upon reversal by this court.*" Heizer Opening Brief, p. 68. (Emphasis added.)

Petitioner also urged in the conclusion of its 67-page post-trial memorandum, filed in the District Court, that deception and fraud were essential elements of 10b-5 liability and that the facts adduced at trial failed to prove either. (R. 80, p. 67)

Petitioner specifically invited the Court of Appeals to review the trial record on the issues of both nondisclosure and scienter, citing *Hochfelder;* expressly noting this Court's grant of certiorari in *Green* (Heizer Opening Brief, pp. 33-42; Heizer Reply Brief, pp. 5-13; 19-20); and citing this Court's ultimate decision therein reversing the Second Circuit Court of Appeals.[13]

In its petition for rehearing in the court below, petitioner expressly stated: "This petition does not question the court's analysis of liability under Rule 10b-5, although Heizer respectfully disagrees with the court's holding in that regard." (Heizer Pet. for Rehrng., p. 2)

Having never raised the question of remand in the Court of Appeals, and, indeed, having taken a contrary position in that court,[14] petitioner may not raise the issue for the first time in its

13. While the appeal in this case was *sub judice,* petitioner brought this Court's decision in *Green* to the panel's attention pursuant to Circuit Rule 11, by letter dated March 31, 1977.

14. Petitioner's briefs in the court below contain extensive analysis and argument of the trial court record. *E.g.*, "From only a

(Footnote continued on next page.)

petition for certiorari. *United States* v. *Ortiz,* 422 U. S. 891, 898 (1975); *Tacon* v. *Arizona,* 410 U. S. 351, 352 (1973); *Adickes* v. *Kress & Co.,* 398 U. S. 144, 147 n. 2 (1970).

II.

THE COURT BELOW CONSIDERED AND FOLLOWED ERNST & ERNST v. HOCHFELDER, SANTA FE INDUSTRIES v. GREEN AND TSC INDUSTRIES v. NORTHWAY, INC. IN DETERMINING LIABILITY.

A. The Fourth Transaction.

1. Scienter.

Petitioner does not dispute in this Court that "recklessness" may properly be considered the equivalent of scienter for purposes of Rule 10b-5.[15] Indeed, it fails to point to anything in the lower court's opinion which conflicts in any way with *Hochfelder.* Its argument on the scienter question, realistically viewed, actually disputes only the sufficiency of the evidence to support the finding below that it acted recklessly. (Pet. 15-20) The writ should not be granted merely to review the sufficiency of the evidence. *General Talking Picture Corp.* v. *Western Electric Co.,* 304 U. S. 175, 178 (1938); *Southern Power Co.* v. *North Carolina Public Service Co.,* 263 U. S. 508, 509 (1924).

But even if this Court were to indulge petitioner's demand that the evidence be reviewed, petitioner has failed to demonstrate that the findings of the court below were clearly erroneous.

(Footnote continued from preceding page.)

brief review of the undisputed facts, this Court can see that there was direct disclosure of all material terms of all financings to the overwhelming majority of the IDC common stockholders as well as the entire IDC board of directors." Heizer Reply Brief, p. 10. And see petitioner's detailed analysis of the trial testimony on deception, scienter and control, *Id.* at pp. 9-20.

15. The Second and Third Circuits have similarly interpreted the scienter prerequisite for Rule 10b-5 liability. *Coleco Industries, Inc.* v. *Berman,* CCH Fed. Sec. L. Rep. ¶ 96,253 (3d Cir. 1977) [current binder]; *Herzfeld* v. *Laventhol, Krekstein, Horwath & Horwath,* 540 F. 2d 27, 36-37 (2d Cir. 1976).

In its opinion the Court of Appeals noted that the District Court had characterized petitioner's conduct in the fourth (as well as the fifth) transaction as "rapacious," but had made no other findings concerning petitioner's mental state (A25). It did not dispute the District Court's finding of rapaciousness,[16] and stated that "The record, however, indicates that defendant's omissions were at least reckless." (*Id.*)

In arriving at this finding the court below began its analysis with recognition of this Court's decision in *Hochfelder*, defining scienter "to exclude mere negligence." (*Id.*) Noting that this Court left open the question of whether reckless behavior was enough, the court, relying on its earlier decision in *Sundstrand Corp.* v. *Sun Chemical Corp.*, 553 F. 2d 1033 (1977) *cert. denied*, ... U. S. ....., 46 USLW 3207 (1977), held that it was. It also cited its contemporaneous decision in *Sanders* v. *John Nuveen & Co., Inc.*, 554 F. 2d 790 (1977), which rejected any liberal standard of reckless behavior. Thus the court below had firmly in mind the standards to be applied when it examined the record in the District Court.

Petitioner strenuously disputes the lower court's analysis of the evidence, and particularly the inferences drawn therefrom. Petitioner would have this Court review the entire record and make findings, contrary to those made below, that (1) petitioner acted on a reasonable belief that full disclosure of all material facts of the fourth transaction had been made; and (2) that petitioner acted in good faith reliance on independent counsel.

The evidence does not and could not support such findings. Rather, when the following undisputed facts are added to those specifically enumerated by the court below (A17-18, 25-26), a finding not merely of reckless conduct but of intent to defraud would be appropriate:

16. Rapacious is defined as "excessively grasping or covetous; given to seizing or extorting what is coveted; subsisting on prey; predaceous." *Webster's Collegiate Dictionary* (1960).

a) At the time of the fourth transaction petitioner was in control of IDC. (Trial Tr. 688)[17]

b) At that time, petitioner's valuation committee valued IDC common stock at $3.60 per share. (PX 48) The record is bare of any evidence that this fact was ever disclosed by petitioner to Jordon Ross when he obtained signatures on the consent forms from the common stockholders although petitioner knew Ross was going to obtain these consents. (Trial Tr. 1146-47) Nor is there any evidence that petitioner ever disclosed its valuation of IDC common stock to Bernard Kury, its counsel, to whom it delegated the task of overseeing the approval procedure. (A25.)

c) The $1.00 per share conversion price of the notes issued in the fourth transaction was not based on any standard valuation criterion (Trial Tr. 695-698), but was fixed by petitioner for the purpose of triggering the anti-dilution clauses in its earlier warrants in order to equalize its pro forma equity with its total investment (Trial Tr. 701). There was no evidence of disclosure of these facts to Bernard Kury, petitioner's counsel, or to Jordon Ross, or of any knowledge of these facts by Kury or Ross, and thus no evidence that petitioner could reasonably have believed that Ross would communicate this information to the consenting stockholders.

d) Petitioner knew that there was virtually no chance that IDC could repay the loans by their maturity date of March 31, 1972 (A49), and thus it knew that triggering

17. Petitioner's statement (Pet. 15) that it was "clearly not in control of the board of directors or the management of IDC" is disingenuous. Jordon Ross testified that he voted in favor of the fourth transaction only because otherwise petitioner would have called its note and forced IDC into bankruptcy. (Trial Tr. 325-326) Under the terms of its earlier agreements with petitioner, IDC could not change the nature of its business without petitioner's consent. (PX 1, § 2.5) If it failed to obtain financing in the fourth transaction, IDC would have had to discontinue the monitoring business, thus occasioning a default; such default would have given petitioner the immediate right to elect a majority of IDC's directors. (PX 10, Certificate of Amendment of Certificate of Incorporation, Art. Fourth I, 4(B).)

of the antidilution clauses was inevitable.[18] There is no evidence that petitioner ever disclosed these facts to Kury, whom it charged with overseeing the approval procedure, or that he had any independent knowledge thereof.

e) Petitioner, through its representatives in IDC's board, knew that Ross had obtained common stockholder consent to the fourth transaction *prior* to director approval of the transaction and *prior* to completion of drafting of the agreement (Trial Tr. 1144-45, 1778, 1784-1785; DX 93, p. 3). As previously noted, petitioner's representatives on IDC's board of directors voted to amend the by-laws of IDC precisely in order to validate these consents. (*supra* at p. 9). Thus, petitioner could not reasonably have believed that Ross could have delivered any documents to the consenting stockholders fully disclosing the terms and conditions thereof.

Given the undisputed facts that the transaction was virtually certain to result in petitioner's acquisition of a claim on 87% of IDC's equity at $1.00 per share; that *only* petitioner knew that this warrant exercise price was fraudulently low in light of its own expert, internal valuation of $3.60 per share; and that *only* petitioner knew that the transaction was designed to trigger the antidilution clauses of its pre-existing warrants; petitioner's factual argument here that it "reasonably believed that any required disclosure had been made" (Pet. 18) is unsupportable. To the contrary, concealment of these facts, as well as those enumerated by the court below, from the consenting stockholders was so highly unreasonable and such an extreme departure from the standards of ordinary care that petitioner had to know of the danger that the stockholders would be misled.

18. The suggestion that petitioner acted in good faith in the fourth transaction because it expected its loans to be repaid prior to March 31, 1972, out of interim financing for which McCormick & Co. was then "looking," (Pet. 9-11) is belied by petitioner's conduct on March 13, 1972. On this date, petitioner loaned IDC another $105,000, on terms governed by the November 19, 1971 agreement. By then, McCormick was no longer trying to find financing, and petitioner admitted that there was no chance of IDC repaying this loan by March 31, 1972. (Trial Tr. 732)

The court below correctly found that, based on the record, petitioner's conduct "was at least reckless." (A25-26)

Nor does the record support petitioner's argument that it "knew that holders of a majority of the stock were fully informed." (Pet. 18) Kury, petitioner's agent, testified that he recollected seeing the consents after they were executed and before the transaction was closed and "adding up the numbers to make certain that an appropriate number of votes were represented by the consents." (Trial Tr. 1146) On their face the consents (PX 16) show that Ross held only 265,800 shares, or approximately 32%, and that neither DeKraker nor Johnston (owning 7% in the aggregate) consented. There is no evidence in the record that Ross actually controlled any more than the 32% which he owned.[19] Nor is there any evidence that any of the other consenting stockholders had any information respecting the transaction, except IDC's counsel (Sigal's law firm) and LaBow, who together owned but three per cent. Thus, contrary to petitioner's assertion (at Pet. 18n* and n.**), the consenting stockholders who might have had knowledge of the transaction owned only 35% of the common stock; and Ross, who owned virtually all of this amount, did not know of petitioner's internal valuation of the stock or its scheme to trigger the antidilution clauses in its warrants.[20]

Petitioner's second contention, that it relied on counsel, and, therefore, could not possess the requisite scienter, is strictly a

19. PX 66, upon which petitioner relies, shows Ross as owning 348,900 shares. This document was prepared by Heizer Corporation, not IDC or Ross. As it conflicts with PX 16, the consent actually signed by Ross, PX 66 must be disregarded.

20. Petitioner's further attempt to buttress its claimed reasonable belief that "any required disclosure had been made" by pointing to the legal opinion issued by IDC's counsel (Pet. 18), is audacious. IDC's counsel admitted that petitioner's counsel participated in drafting the critical language of that opinion. (Trial Tr. 1787-1788) This being the case, petitioner should not assert, even by implication, that it relied in good faith upon that opinion as an opinion of *independent* counsel. In any event, that opinion says nothing at all about disclosure of the terms of the fourth transaction to anyone.

defense, which, if not required to be pleaded as an affirmative defense, at least must be proved at trial by the defendant asserting it. Petitioner did neither. It failed to plead or otherwise raise this defense either in the trial court or in the court below, and now appears to do so as an afterthought. But petitioner's own authorities (Pet. 16-17), require a defendant, at a minimum to prove, *inter alia*, that there was actual reliance on an erroneous opinion of counsel, and that a full disclosure of all material and relevant facts was made to counsel rendering the opinion. *Hawes & Sherrard*, "Reliance on Advice of Counsel as a Defense in Corporate and Securities Cases," 62 *Va. L. Rev.* 1, 19, 29, 38-39 (1976). A further element of the defense is that the opinion sought must be on a complex legal question requiring expertise not possessed by defendant; reliance on the attorney to perform certain acts or otherwise serve as agent or delegee of defendant is wholly insufficient to negate scienter. *Hawes & Sherrard, supra*, at 101, 115, 128, and cases cited therein.

On every one of the above elements of proof, the record ridicules petitioner's belated "reliance on counsel" claim. It did not seek or obtain from counsel a legal opinion on the adequacy of disclosure to IDC's shareholders; it merely delegated to an agent, who happened to be its attorney, the task of obtaining stockholder consents. The record is devoid of evidence that petitioner itself ever disclosed to Kury, its counsel, all material facts relative to the fourth transaction, *e.g.*, its valuation of IDC stock and intentional triggering of the antidilution clauses of its warrants, see text, *supra*, at 21-22. Petitioner was a specialist in investing in the securities of other companies (A44), and, being owned itself by public investors (banks, pension funds, universities) (A5), did not and could not prove that fair disclosure of the fourth transaction was so complex and so far beyond its own expertise as to require, let alone justify, total reliance on counsel.

Plainly recognizing that it failed to plead, prove, or even argue this defense below, petitioner boldly tries to shift the

burden of proof on the issue to respondents. It asserts, utterly without support in the authorities cited, Pet. 16-17, that "there can be no finding of scienter absent affirmative evidence of some knowledge on the part of the defendant that the attorney would probably act improperly." (Pet. 16) Petitioner then includes in its catalogue of "evidence" challenging the lower court's finding of reckless conduct, the statement, "the attorney on whom petitioner principally relied had acted with demonstrated care in the past." (Pet. 20) Both petitioner's purported legal rule and its contention of fact based thereon are merely efforts to finesse fatal weaknesses in its evidentiary attack on the lower court's holding. The writ should not be granted to review such shallow claims of error.

2. Vicarious Liability.

Neither the District Court nor the court below based its finding of liability in the fourth transaction on Section 20(a) of the Securities Exchange Act of 1934, 15 U. S. C. 78t(a) ("controlling persons"), or the common law doctrine of *respondeat superior*. Nevertheless, petitioner raises a straw man and argues that *"if"* the court below intended a finding of vicarious liability, such finding was error because the evidence "could have sustained" the statutory defense provided in Section 20(a).[21] (Pet. 20-21)

Petitioner then argues that, because evidence of the statutory defense was ignored, the court below must have based its finding of liability on the common law doctrine of *respondeat superior*, in conflict with other circuits, a conflict which should now be resolved in this case. (Pet. 21)

The simple answer to this attentuated argument is that this Court does not sit to adjudicate hypothetical questions. However,

21. ". . . unless the controlling person acted in good faith *and* did not directly or indirectly induce the act or acts constituting the violation or cause of action." (Emphasis supplied.)

assuming *arguendo* that the Court of Appeals intended a finding of vicarious liability, petitioner's point again reduces to no more than an evidentiary dispute. The predicate of petitioner's argument is that the evidence established a defense under Section 20(a). If it did not, then the question whether the doctrine of *respondeat superior* was improperly applied becomes irrelevant and need not be decided by this Court in this case.

The court below found that petitioner was IDC's controlling stockholder who chose to participate in communications to the IDC stockholders. (A18-19) These facts are not in dispute. The court's conclusion that as a fiduciary petitioner owed the stockholders "the duty of full disclosure" (A19) is hardly arguable, especially in a self-dealing transaction between petitioner and IDC. Nor can there be any dispute that Kury, petitioner's agent, at petitioner's direction, and with its knowledge and approval, directly participated in and arranged for the consents to the fourth transaction.[22] (A18, A25-26) Accordingly, there is ample evidence that petitioner, as a controlling person, directly or indirectly, *induced* the uninformed consents from IDC's independent common stockholders; there is no evidence to the contrary.

Respondent has heretofore addressed the question of petitioner's asserted "good faith" in the fourth transaction. (Pages 20-23, *supra*) But having failed to establish one leg of its defense —that it *"did not* directly or indirectly *induce* the act or acts constituting violation"—the other leg, "good faith" becomes immaterial. The statutory defense is in the conjunctive: unless *both* elements are satisfied, the defense must fail.

Moreover, where the transaction is for the benefit of the controlling person, actual knowledge of the specific wrongdoing

22. Viewed from the perspective of Section 20(a), Ross too may properly be considered to have been petitioner's "controlled person" at the time of the fourth transaction. At that time Ross was Chairman of the board of IDC (PX 59). The statute requires "only some indirect means of discipline or influence short of actual direction to hold a 'controlling person' liable." *Myzel* v. *Fields,* 386 F. 2d 718, 738 (8th Cir. 1967), *cert. denied,* 390 U. S. 951 (1968).

need not be shown; it is sufficient that the controlling person directly or indirectly induced the transaction. Otherwise, Section 20(b) of the Act[23] would be vitiated. *Myzel* v. *Fields,* 386 F. 2d 718, 738-39 (8th Cir. 1976), *cert. denied,* 390 U. S. 951 (1968).

B. The Fifth Transaction.[24]

1. Scienter.

By the time of the undisclosed fifth transaction, petitioner was in control of IDC's board of directors. (A19) The District Court found that petitioner's conduct in that transaction "was even more rapacious" (A64) The Court of Appeals found that it "bespeaks a reckless disregard of its duty to disclose" because the pledge was for its benefit and thus would arouse a great deal of opposition. "Yet it *consciously* decided, through Heizer counsel, not to take the proposal to the shareholders." (A26). (Emphasis added.)

Petitioner suggests that these are findings of no more than a breach of fiduciary duty, not scienter (Pet. 23), as if the former necessarily excluded the latter. What petitioner would ignore, but what the court below expressly noted, is that the fifth transaction was designed by petitioner to thwart the pending lawsuit and make it impossible for the District Court to grant

23. "(b) It shall be unlawful for any person, directly or indirectly, to do any act or thing which it would be unlawful for such person to do under the provisions of this chapter or any rule or regulation thereunder through or by means of any other person."

24. Petitioner suggests that the only securities involved in the fifth transaction were short-term notes, and therefore no purchase or sale of a "security" was involved. (Pet. 22n.*) Petitioner ignores the fact that in that transaction IDC conveyed all of the stock of its subsidiary to petitioner by a pledge under which IDC surrendered all voting rights to the stock, and under circumstances where default thereunder was a virtual certainty. (PX 25; A64) Thus in reality IDC parted with its entire interest in the stock of T & R. Such transaction was well within the statutory definition of a sale. 15 U. S. C. 78(c)(14). In any event, since there were independent grounds for voiding the pledge (A27-28), this Court need not consider the question whether the notes were securities. See page 33, *infra.*

any effective relief should plaintiffs prevail. (A12, 24, 26) These facts are not disputed. Concealment of the pledge, and especially its true purpose, was *essential* to petitioner's scheme. Accordingly, the finding of the court below that petitioner *consciously* decided not to take the proposal to the shareholders is amply supported by the evidence. While the court characterized petitioner's conduct as reckless, it comes well within the definition of scienter, "a mental state embracing intent to deceive. . . ." *Ernst & Ernst* v. *Hochfelder*, 425 U. S. 185, 193 n. 12 (1976).

Further evidence of petitioner's intentional deception may be found in its subsequent conduct. Two months after the pledge, IDC's president wrote to the stockholders reporting on past and current operations. Buried on the fifth page of that seven-page letter was a single paragraph disclosing the pledge.[25] No disclosure was made (a) of the true purpose of the pledge (*i.e.*, to insulate petitioner from the possible adverse outcome of the litigation); (b) of the total amount of indebtedness secured and to be secured thereby; (c) of the fact that there was no possibility of repayment of this indebtedness by January 2, 1974; or (d) of the value of the asset pledged. Thus, even when it decided to reveal the existence of the pledge, petitioner

25. "As soon as possible we plan to present specific financing plans to the stockholders for their consideration.

"In the meantime, the Company needs funds to support the monitoring program recommended by management. The Heizer Corporation is willing to continue to provide such funds. However, in the light of current law suits, Heizer Corporation requested that T&R stock be pledged as security for non-equity demand debt now owed to Heizer Corporation and such additional funds as may be advanced by Heizer Corporation in 1973. Accordingly, in June, 1973, the Company entered into an agreement with Heizer Corporation whereby the Company pledged the stock of T&R in return for Heizer Corporation's agreement to extend the Company's current debt until the end of the year provided that the Company's stockholders approve the financing plans to be submitted to them, and to advance additional funds during 1973 provided the Company meets certain projections. It is our hope that this will enable the Company to carry on the monitoring program and to complete its financing plans." (PX 53, p. 5)

carefully concealed its material terms in order to avoid any adverse response from the common stockholders.

Under the foregoing circumstances, application by the court below of the reasoning in *Bailey* v. *Meister Brau, Inc.*, 535 F. 2d 982, 993-94 (7th Cir. 1976), was particularly appropriate. Petitioner's conflict of interest was so glaring as to be blinding; disregard of the unfairness of the pledge, and failure to make disclosure thereof, can only be described as wanton.[26]

2. Deception.

Petitioner does not dispute the fact that there was no disclosure to the independent shareholders of IDC of any of the terms of the fifth transaction prior to its consummation. It admitted as much in its answer (R. 63, ¶ 25), and the court below so found. (A20) Nor does petitioner quarrel with the holding of the court below that disclosure was required because these facts were material. (A21-24) Petitioner merely contends that, since it made *subsequent* disclosure, before the transaction had become "irrevocable," its failure to make prior disclosure was excused.[27] (A24)

Petitioner's attack on the reasoning of the court below is erroneous both as a matter of fact and law.

Contrary to petitioner's assertion (A24), the Court of Appeals did *not* conclude "that there was reasonably prompt disclosure of the transaction to the stockholders after it was approved." What the court said was that "the shareholders were first informed of the *general terms* of the pledge and the reasons therefor two months after the transaction." (A20-21). (Emphasis

26. Reliance by petitioner on *Cole* v. *Schenley Industries, Inc.*, CCH Fed. Sec. L. Rep. ¶ 96,166 (2d Cir. 1977) (Pet. 23) is misplaced. Contrary to the present case, the court there expressly found that there had been full disclosure of the material facts. (*Id.* at p. 92,288)

27. In its answer to the second amended complaint petitioner admitted that there was no disclosure of the terms of the fifth transaction either before or *after* its consummation. (R. 63, ¶ 25)

added.) But that information contained in a single paragraph of a seven-page letter from IDC's president (reproduced in pertinent part, *supra*, note 26) was, as heretofore shown, more deceptive than informative. The record is bare of any evidence that petitioner, or IDC, ever informed the shareholders of all of the material terms of the pledge, including petitioner's true purpose in extracting it from IDC.[28] Absent the fundamental premise of petitioner's argument, that there was reasonably prompt and adequate disclosure of the transaction after its consummation, petitioner's conclusion is fatally flawed. In sum, petitioner is asking this Court to decide yet another purely hypothetical question: whether, *assuming* prompt and full disclosure after the transaction, petitioner's statutory duty under Section 10(b) was discharged.

The balance of petitioner's defense of the fifth transaction relies on a distortion of this Court's reasoning in *Green*. There, in addressing itself to the *materiality* of the alleged nondisclosure, this Court concluded that, since the shareholders could not have prevented the transaction, even in a state court injunction proceeding, prior disclosure would have been meaningless and, therefore, the information allegedly concealed was not material; hence advance notice was not required. 430 U. S. at 474 n. 14. The court below followed this reasoning in determining that, in the present case, the terms of the fifth transaction were material and that prior disclosure was required, since respondents could have obtained a state court injunction to enjoin the transaction. (A21-22).

Petitioner seizes upon this narrow holding on the issue of materiality and would transform it into a general proposition that disclosure of material facts required under Section 10(b)

28. The pledge was consummated in June, 1973. The case was tried in March, 1974. Petitioner introduced no evidence at trial of any post-transaction disclosure of either the terms of the pledge or the reasons for its existence. Plaintiffs' knowledge of the terms of the pledge and related facts was obtained through discovery in the present case.

may be made *at any time*, at the option of the defendant, even months after the transaction, so long as it has not become "irrevocable."[29] (Pet. 24) Petitioner's peculiar reading of *Green* totally ignores the specific language of Section 10(b), as well as Rule 10b-5, which requires disclosure *"in connection with"* the securities transaction. But, the starting point in every case involving construction of a statute is the language itself. *Ernst & Ernst* v. *Hochfelder*, *supra*, at 197. Petitioner leaves unexplained how disclosure can be made months after conclusion of a transaction, and still be "in connection" therewith.

The gravamen of the decision below was not, as petitioner argues, mere breach of fiduciary duty by a controlling shareholder (A24), but intentional concealment of material facts from the corporation's independent shareholders when a duty of disclosure existed. That the transaction may also have amounted to a common law breach of fiduciary duty can hardly stand as a reason for denying respondents a remedy under Section 10(b). *Goldberg* v. *Meridor*, CCH Fed. Sec. L. Rep. ¶ 96,162 (2d Cir. 1977), [current binder]. *Only* when full and fair disclosure has been made is the fairness of the transaction reduced to tangential concern of the statute. *Santa Fe Industries* v. *Green*, *supra*, at 478.

3. Causation.

Petitioner's criticism of the lower court's finding of causation[30] parallels its challenge to the finding of deception. Petitioner perceives some unarticulated error in the court's reasoning because it "inextricably intertwined the concepts of fiduciary

29. Petitioner does not define the term "irrevocable" in this context, but its argument suggests a post-transaction time frame beyond which equitable relief voiding the transaction would not be available in a state court. There is nothing in the record in the present case which establishes that, in a *state court proceeding*, brought months after the fifth transaction, and doubtlessly adjudicated many months after that, a chancellor would necessarily have granted such relief at the instance of an independent shareholder of IDC.

30. The Court of Appeals discussed this question in terms of both reliance and causation. (A21-24)

duty and state corporate common law with the federal securities laws . . ." (A 26)

The argument that breach of fiduciary duty on the one hand, and securities fraud on the other, are mutually exclusive concepts is irrational. In the real world transgressions are not subject to such simple separation and labeling. "The Congress made clear that 'disregard of trust relationships by those whom the law should regard as fiduciaries are all a single seamless web' along with manipulation, investor's ignorance, and the like." *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U. S. 6, 11-12 (1971). "[T]he statute provides a cause of action for any plaintiff who 'suffer[s] an injury as a result of deceptive practices touching its sale [or purchase] of securities . . .'" *Santa Fe Industries, Inc.* v. *Green, supra,* at 476, quoting *Superintendent of Insurance, supra.*

Thus, as this Court has twice said, deception in a securities transaction is not removed from the reach of the statute merely because, in committing the fraud, the defendant also breached his common law fiduciary duty.

The court below related its finding of reliance to its finding of materiality. Applying this Court's decision in *Affiliated Ute Citizens* v. *United States*, 406 U. S. 128, 153 (1972) the court held that if the omitted information was material, reliance is presumed. (A21) As above argued (p. 30), in determining materiality in the context of the fifth transaction, the court first made the necessary finding that, given advance disclosure of the information, the independent shareholders would not have been powerless to prevent the transaction. It was only in this narrow context that the court directed its inquiry to the fairness of the transaction to determine whether a "causal link" existed between the nondisclosure and consummation of the transaction. (A22)

Petitioner's unjustified criticism is bottomed on its misreading of the lower court's opinion. Nowhere in its opinion did the court below depart from the teaching of *Green* that deception

is a necessary element of Section 10(b) liability. Nor, in light of the command in *Green*, could it have grounded its finding of liability on a breach of fiduciary duty and nothing more. To the contrary, upon careful analysis the court expressly found that the record proved each element of Section 10(b) liability: nondisclosure; materiality; scienter; reliance; and causation. Once again petitioner is disputing nothing more than the sufficiency of the evidence to prove these elements.

4. Alternative Grounds for Relief.

The Court of Appeals held the pledge void even if petitioner's conduct in the fifth transaction "was not in itself actionable under Rule 10b-5." (A27) It was undisputed that the purpose of the pledge was to insulate petitioner from liability in the event it was found to have deceived the corporation in the other transactions, and the court below so found. (*Id.*) Accordingly, because it was a consequence of petitioner's statutory violation in the fourth transaction, the court found it to be void on this wholly independent ground. (A27-28)

Petitioner nowhere challenges this independent ground for relief in the fifth transaction, except to the extent that it disputes liability in the fourth transaction. Accordingly, if the lower court's finding of liability in the fourth transaction was correct, petitioner must be deemed to have admitted liability in the fifth, irrespective of any claimed absence of deception and scienter therein.

III.

THE ISSUES RAISED IN THE PETITION RESPECTING RELIEF WERE NEVER RAISED BELOW. THE RELIEF GRANTED WAS WELL WITHIN THE STATUTORY AND EQUITY POWERS OF A FEDERAL COURT.

A. The Issues Are Raised for the First Time in the Petition.

Petitioner argues that in changing the convertible notes to nonconvertible notes, and in extending the maturities of the demand loans, both courts below exceeded their statutory

powers. In petitioner's view the statute provides for either damages or total rescission, but does not permit reformation. (Pet. 27-29) Petitioner also urges that, with respect to the prospective relief granted, neither court below made the requisite findings of irreparable injury or inadequacy of a remedy at law. (Pet. 30)

Petitioner raised neither of these issues below.[31] Having failed to do so, it should not be permitted to raise them for the first time in this Court, *United States* v. *Ortiz, supra; Tacon* v. *Arizona, supra; Adickes* v. *Kress & Co., supra.*

B. The Relief Granted Was Within the Power of the Lower Courts.

1. Reformation of the Convertible Notes and Demand Loans.

Petitioner's argument that the lower courts had no power to cancel the convertibility feature of the convertible notes or adjust the maturities of the demand loans is unsupported by any authority. The controlling decisions of this Court are to the contrary.

In *Mills* v. *Electric Auto-Lite Co.*, 396 U. S. 375, 386 (1970) this Court said:

> "In selecting a remedy the lower courts should exercise 'the sound discretion which guides the determinations of courts of equity,' keeping in mind the role of equity as 'the instrument for nice adjustment and reconciliation between the public interest and private needs as well as between competing private claims.'"

More recently, in *Rondeau* v. *Mosinee Paper Corp.*, 422 U. S. 49, 63 (1975) this Court affirmed its earlier view in *Deckert*

31. It is true that the relief reforming the demand loans was granted for the first time in the Court of Appeals' modified opinion issued after consideration of petitioner's Petition for Rehearing in that court. But the relief reforming the convertible notes issued in the fourth transaction to nonconvertible notes was granted *in the first instance by the District Court*. Thus the power of the court to order reformation could have been but was not raised by petitioner in the Court of Appeals.

v. *Independence Shares Corp.*, 311 U. S. 282, 288 (1940), that the power of a federal court to make the right of recovery effective under federal securities laws implied the "power to utilize any of the procedures or actions normally available to the litigant according to the exigencies of the particular case."[32] Earlier this Court had said that it is for the federal courts to adjust their remedies so as to grant the necessary relief where federally secured rights are invaded. *J. I. Case Co.* v. *Borak*, 377 U. S. 426, 433 (1964).

Accordingly, while the 1934 Act does permit relief by an award of damages or by voiding a transaction in its entirety, petitioner's argument that these are the *sole* remedies available for violation of the statute is inconsistent with the foregoing decisions of this Court.

The necessity for the adjustment of the notes under the equitable power of the lower courts is clearly demonstrated by the exigencies of this case.

Had the District Court been limited to voiding the fourth transaction in its entirety, no equitable relief[33] at all would have been possible. Voiding the transaction entirely would have required immediate repayment by IDC to petitioner of the full $819,000 consideration received for the convertible notes, a condition that was impossible in light of IDC's cash position. The equitable relief required was the limited reformation excising the conversion feature of the notes, the feature which was the *sine qua non* of petitioner's fraud. Since this was all that was required under the exigencies of the case, this was the relief which the District Court granted.

Insofar as the demand loans were concerned, rescission was even more impossible. Immediate repayment of the entire $5

32. There is nothing in *Deckert* to support petitioner's suggestion (Pet. 28n*) that the case was limited to relief *pendente lite* or ancillary relief.

33. Petitioner never suggested below that money damages be awarded in lieu of equitable relief. Nor does it suggest in this Court how such damages might have been computed.

million in demand loans would have required the liquidation of IDC, the very result which the Court of Appeals had determined that petitioner was to be denied. (A30)

Petitioner's additional complaint that the retrospective relief awarded was punitive (Pet. 28) is plainly specious. Petitioner is no different than any other law violator who has been denied the fruits of his fraud. If such relief is to be deemed "punitive," and thus beyond the limits of the 1934 Act, then those who profit by defrauding others will be licensed to do so by the very statute designed to protect investors against such conduct. It is hardly possible that Congress intended any such result.

Equally specious is petitioner's argument that it has been deprived of its property without due process of law. (Pet. 29) Petitioner has been deprived of nothing except that which it obtained through fraud. It still retains its notes and ultimately should recover their full amounts (A31), including interest.

Finally, petitioner's attempt to plead the doctrine of *in pari delicto* (Pet. 28, n.**) comes too late. It never raised the issue below. Nevertheless, petitioner's reliance on *Tarasi* v. *Pittsburgh National Bank*, 555 F. 2d 1152 (3d Cir. 1977) is misplaced. That case held that the defense of *in pari delicto* barred a Section 10(b) action by a "tippee" against his "tipper." 555 F. 2d at 1164. No such facts are present in this case. The present case is a derivative action in which any violation of law committed by IDC was as a result of petitioner's control. The defense of *in pari delicto* is not available against a plaintiff whose conduct was passive and coerced.[34] 555 F. 2d at 1162.

2. Prospective Relief.

While it made no such argument below, petitioner now belatedly complains that the lower courts did not make findings of "irreparable injury" or "inadequacy of a remedy at law"

34. Jordon Ross was never a party in the case and was not granted any relief by the lower courts. In November, 1977, petitioner sued Ross for contribution, *Heizer Corporation* v. *Jordon Ross*, No. 77 C 4162, N. D. Ill.

in granting prospective injunctive relief. The record shows otherwise.

The District Court granted such prospective relief "because of the dominant position which Heizer holds in relation to IDC and its clear over-reaching in the fourth and fifth transactions." (A66) The Court of Appeals found that "There is sufficient basis for the District Court's determination that some kind of restraint on future abuses is warranted." (A32) It also spelled out its own reasons for determining that prospective relief was necessary. (A32-33) By these findings the lower courts thus necessarily found that, unless restrained, petitioner would inflict irreparable injury on IDC and its common shareholders in the future. Conversely, there was no showing by petitioner that it intended to comply with the law in the future, and indeed, its repeated violations demonstrated that it had no intention of abandoning its buccaneer philosophy. Accordingly, there was some "cognizable danger of recurrent violation" sufficient to warrant the injunction. *United States* v. *W. T. Grant Co.*, 345 U. S. 629, 633 (1953).

Petitioner seems to suggest that, in issuing an injunction, a court is obliged to use the magic words "irreparable injury" and "inadequacy of a remedy at law." No such requirements appear in Rule 65(d), Fed. R. Civ. Pr., and petitioner cites no authority mandating these specific words. All that the Rule requires is that the order granting the injunction "set forth the reasons for its issuance." As shown above, both courts below complied with this requirement.

Nothing in the opinion of either lower court conflicts with *Rondeau* v. *Mosinee Paper Corp.*, 422 U. S. 49 (1975). Neither court excused the traditional requirement that irreparable injury be shown before an injunction may issue under the federal securities laws. Both courts clearly found that petitioner's conduct caused IDC and its common shareholders irreparable injury in the past and threatened such injury in the future. Considering that twice during the course of this litigation petitioner deliber-

ately attempted to subvert the lower courts' jurisdiction,[35] the finding of the Court of Appeals that "some kind of restraint on future abuses is warranted" may be considered an understatement.

Again, petitioner disputes nothing more than the sufficiency of the evidence to support the findings of the lower courts. As heretofore argued, the writ should not be granted merely to review the sufficiency of the evidence.

CONCLUSION.

Petitioner's broad-axe assault on the Seventh Circuit (Pet. 13) is unwarranted and irrelevant to this case. Petitioner cannot disguise the fact that its petition presents no questions worthy of this Court's review. As revealed in its argument, petitioner merely disputes the sufficiency of the evidence supporting the lower court's findings on liability and relief, or raises issues which it failed to argue below.

Respondents respectfully urge that the petition be denied.

Respectfully submitted,

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35. The fifth transaction occurred while the case was pending in the District Court. Petitioner's plan of recapitalization was attempted while the case was on appeal but had been remanded to the District Court for certain limited purposes.